

Sound Investments Inc.

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Summary

With price to earnings ratios back at their long-term average, stocks have less ability to deal with disappointments, or even news that matches expectations.

On the back of this page, there is a chart of the Dow Jones Industrial average from 2002 to January 2010. This is known as a channel chart depicting the high and lows over the years. The stock market broke through the lower channel in late 2009 and is now trying to break through again. This lower as ascending line now becomes resistance and makes it difficult for the market to go higher. At this point the market will likely **zig zag back and forth** awaiting more positive news

The Investment Letter is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research.

Good Riddance to the '00s.

History suggest that things will be better over the next 10 years.

The last 10 years it was "dea horribilis" for the average American Investor.

Overall, the last 10 years have been the worst on record for U.S. stocks, dating all the way back to the 1820's. Stocks fell on average 0.5% annually. It was especially cruel to most retail investors as they came to expect a 10% annual return after the raging bull markets of the 1980s and 1990's where stocks rose on average 16.6 and 17.6% respectively. The S&P fell an average of 3.3% and the NASDAQ did even worst. We avoided most of this by heavily investing in international stocks and switching to cash in 2008.

A Short Update On the Last Quarter

The nearly 10 month rally in stocks continued with the Dow Jones tacking on another 22.8% and the S&P up 28.3% over the last 12 months. International funds continue to do even better.

The weakening dollar and low yields again boosted stocks and all other forms of risk assets, a pattern that has repeated for months. A cheaper U.S. currency helps strengthen foreign demand for commodities (i.e. oil, copper etc.) which in turn boosts the value of energy and material stocks.

As outlined below economic reports remain mixed but points to a strengthening trend. We are still reeling from the housing crisis and the painful deleveraging process which will likely take longer than we like. The market has travelled a long way without a meaningful correction since the lows of March 2009. With price to earnings ratios back at their long-term average, stocks have less ability to deal with disappointments, or even news that matches expectations.

Two Questions

The performance of the U.S. stock markets will boil down to two questions: 1.) Will the S&P 500 companies eke out the profit expected of them? 2.) Will retail investors, burned by a negligible returns and a year of financial distress leap into the stocks again, as professional investors and mutual funds have?



The above Chart of the Dow Jones average from 2002 to Jan 2010. I have labeled the ascending channel above. This may act as a temporary roof on the market.

It may take several attempts before the Dow makes it through this ascending channel but it should push higher assuming more positive economic s data.

With respect to the 1st question concerning earnings:

- Industrial production rose for fourth time in 5 months in November. It posted a solid gain of .8%
- Capacity utilization increased again in November to 71.3% from 70.6% in previous month. The long-term rate is 81%.
- Retail sales rose 1.3% in November.
- With exception of the banking, sector corporate balance sheets are in good shape.
- The consumer price index rose 0.4% in November which brings the year over year inflation rate to 1.8%
- Based on articles in Barons we are increasing our earnings estimate for the S&P 500 index to 74.50. Given this earnings estimate and a fair value price / earnings ratio of 16 to 17 times operating earnings the upside potential of the S&P 500 at 1200 to 1260. The index is currently at 1100. The bottom line is the economy is perking along nicely as the new year gets underway. In the quarter just ended gross domestic product increased by 3 to 4%; a material faster pace than the third quarter 2.2% rate of improvement.

With respect to the 2nd question poised above concerning peoples' willness to invest with memories of the past decade of negligible returns. Many people are still in denial and haven't accepted that we are in the early stages of a bull market. In some ways this is more of a psychological issue. People continue to hear about foreclosures, layoffs, high government spending and are concerned with their financial future, especially if they are nearing retirement. What we are looking for is a return to normal. It will come organic consumer spending growth take the place of the government spending effort. Or, in other words, can we transition from a government-led repair to private-led recovery? Housing prices are starting to firm up which should help. For funds invested in qualified plans like IRA's and 401K plans equity assets are clearly the best alternative to low rate CD's or government bonds. I have been able to attract a number of new clients and my experience dealing with them is that they are less willing to take on risk.

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What We are Doing Now

Different funds tend to thrive in different periods of the bull market. In the early stages top performers tend to be riskier funds – those funds that are holding companies that are most Vulnerable to an economic downturn and which therefore lost the most. Stocks that lost the most tend To bounce off the bottom and regain ground when the market turns around.

However, as the bull market matures, leadership typically shifts to larger, higher quality companies. Multi-nationals are in the best position to take advantage of global growth. They can capitalize on a weak dollar and economic strength outside the U.S.

Conclusion

The stock market can move higher, but recent price strength now makes future gains less well assured. As always, we will continue to monitor the situation and take corrective action when needed.